

VZCZCXYZ0000
RR RUEHWEB

DE RUEHTA #0779/01 1121152
ZNY CCCCC ZZH
R 211152Z APR 08
FM AMEMBASSY ASTANA
TO RUEHC/SECSTATE WASHDC 2267
INFO RUCNCIS/CIS COLLECTIVE 0490
RUCPDO/DEPT OF COMMERCE WASHDC
RHEBAAA/DEPT OF ENERGY WASHDC

C O N F I D E N T I A L ASTANA 000779

SIPDIS

SIPDIS

STATE FOR SCA/CEN, EEB
COMMERCE FOR HUEPER
ENERGY FOR EKIMOFF

E.O. 12958: DECL: 04/17/2018
TAGS: [PGOV](#) [PREL](#) [EPET](#) [KZ](#)
SUBJECT: GOK INCREASES PRESSURE ON TENGHIZCHEVROIL OVER
SULFUR

REF: ASTANA 206

Classified By: AMBASSADOR ORDWAY FOR REASONS 1.4 (B) AND (D)

¶1. (C) Summary: Kazakhstani authorities continue to closely scrutinize TenghizChevroil (TCO), which has already paid hundreds of millions of dollars in fines in recent years. Consortium representatives describe a working environment made difficult by government harassment and constant requests for information. TCO's most serious problem concerns sulfur production and storage. It has already paid a \$300 million environmental fine for storing sulfur without official permission, and now faces an additional \$300 million administrative penalty connected to the original fine. Chevron CEO David O'Reilly met with President Nazarbayev on April 15, with the sulfur issue a primary topic of conversation. End Summary

TCO Under Scrutiny

¶2. (C) TCO, which is owned by Chevron (50%), KMG (20%), ExxonMobil (25%), and LukArco (5%), has been fined by both national and regional authorities on numerous occasions in the last year. Most significantly, TCO was fined over \$600 million dollars for storing 2.5 million tons of sulfur without official permission. The fine was later reduced to \$300 million by an Atyrau regional court. TCO now faces an additional \$300 million administrative penalty connected with the alleged environmental violations. On April 15, Chevron CEO David O'Reilly met with President Nazarbayev in Astana and urged the Kazakhstanis to work towards an equitable solution on the sulfur issue. TCO has also paid a series of smaller fines. For example, the environmental prosecution department of the Atyrau Oblast brought environmental charges against TCO for excessive gas flaring in 2007, for which TCO paid a \$12 million fine. Kazakhstan's Ministry of Environment charged TCO with 22 environmental violations subject to civil penalties of \$1.1 million dollars.

¶3. (C) In a meeting with Poloff on April 12, Linsi Crain, TCO Deputy Manager for Government and Public Affairs, and Mark Maurer, TCO Finance Manager, said that interference and harassment from Kazakhstani authorities is unrelenting. The Kazakhstanis, they said, are looking for every opportunity to "find a hole." Maurer stated that TCO receives fifteen threatening letters a week. Crain described TCO as constantly in reactive mode because of the intense scrutiny. Pete Clark, Chevron Eurasian Business Unit Manager for Strategic Planning, told Poloff in a separate meeting on April 5 that Chevron is in a defensive position at Tenghiz,

trying to preserve contract sanctity. Realistically, said Clark, Chevron will suffer reduced earnings at Tenghiz, but "we are trying to hold off as much as possible." "Every time we fix one problem, another arises," he added.

14. (C) Crain, Maurer, and Clark were extremely critical of the latest sulfur fines. Clark noted that when O'Reilly met with President Nazarbayev last year, Nazarbayev promised to instruct Prime Minister Masimov to solve the sulfur conflict. Despite Nazarbayev's promises, the Kazakhstanis have not relented on sulfur. TCO cannot go to the Ministry of Energy and Natural Resources for permits on storage, because such permits do not even exist. Maurer said that TCO believes that it can take a royalty offset for the \$300 million environmental fine. The Ministry of Finance, however, disagrees. According to Maurer, TCO may at some point decide to challenge the government by taking the offset, or file a notice of arbitration.

15. (C) Crain said that TCO sold 2.05 million tons of sulfur in 2007, with sales equaling 126% of production and an increase of 24% from 2006. Total sulfur on pads was reduced by nearly half a million tons in 2007, and new projects are underway to increase sales capacity to three million tons per year. TCO prepares a biweekly report for the Kazakhstanis on sulfur, but still has faced accusations that it is not doing everything possible to sell its sulfur. Crain said that TCO has enough clients for its sulfur, but faces issues of transportation capacity.

16. (C) When asked why TCO is facing such intense oversight, Maurer replied that "it is strictly about the money." Patty Graham, ExxonMobil Kazakhstan Government and Public Affairs Representative, told Poloff that she has heard the fines are linked to the budget concerns of regional governments. Clark

echoed Graham, saying that Tenghiz fines have become an essential part of the Atyrau Oblast budget. Courtney Fowler, a partner at PriceWaterhouseCooper (PWC) in Almaty, told Poloff on April 6 that once after a large fine against TCO was upheld by the Kazakhstan courts she overheard the Atyrau Akim saying "Why so much? I only needed \$7 million." (Note: In the end, all of the \$300 million sulfur penalty went to the central authorities).

17. (C) Although acknowledging that Chevron's partnership with Kazakhstan at Tenghiz has been extremely profitable for all parties, Clark admitted that the relationship is not without cause for occasional concern. Chevron would like to think that it is irreplaceable, he said, because of the value and reliability it provides to the project. Nevertheless, "there are ways we could be replaced," he said, particularly with the project personnel increasingly Kazakhstani. Chevron will be most vulnerable, believes Clark, after completion of second stage expansion. (Comment: We think this is exaggerated. KMG does not have the ability to manage this project for the foreseeable future.)

18. (C) The story is slightly different from the GOK perspective. Energy Minister Mynbayev has told visiting USG delegations and the Ambassador that his ministry will "have to get more involved" to resolve the sulfur problem. Senior management at KMG is also reasonably aligned with KMG on this issue. Prime Minister Masimov confirmed to the Ambassador on April 17 that President Nazarbayev had promised Dave O'Reilly (again) that the sulfur issue will be solved. Masimov said that the President has turned this problem over to him and that he has not yet figured out how to resolve it.

The Bigger Picture

19. (C) Westerners with links to Kazakhstan's energy sector told Poloff that problems at Tenghiz are part of a broader pattern of behavior by the GOK. PWC's Fowler believes that the GOK is "layering one tax after another" on the IOCs and using tax and environmental laws as "extortionary tools." She assessed the energy investment climate as worsening. Marla

Valdez, a partner at the law firm of DentonWildeSapte in Almaty, believes that there is "no doubt that the government is tightening up." Patty Graham of ExxonMobil believes that the recently announced oil export duties will also place additional pressures on western companies, even though it will not directly affect companies operating under tax-stabilizing contracts. Attention is sure to shift to the IOCs, believes Graham, when local companies begin to bear the brunt of the export tax.

¶10. (C) Nevertheless, no one is yet proclaiming that the sky is falling. Graham sees clear distinctions between Kazakhstan and countries such as Venezuela and Russia and does not believe Kazakhstan will follow their path. Valdez reported that companies are still coming in to Kazakhstan to make acquisitions, describing DentonWildeSapte's acquisitions services as "booming." Fowler noted that Kazakhstan has some promising leaders who have the right vision for Kazakhstan's energy sector, praising Presidential Administration Head Kairat Kelimbetov in particular.

¶11. (C) The biggest issue is contract sanctity. Despite the large numbers involved in the long-running sulfur dispute, most of the GOK's actions against the IOCs are based on contract provisions that the government construes in their favor and the IOCs argue strenuously are clearly in their favor. While the companies are quick to say they will go to arbitration, it is in the interest of neither side to let the situation get so far out of hand - and an acceptable compromise is inevitably found. More broadly, Masimov has told the Ambassador on several occasions that existing contracts will be honored as long as Nazarbayev has anything to say about it - a view that the companies largely echo. However, the contracts are vulnerable to attack in the longer run if they are in conflict with subsequent tax and other legislation. Masimov told the Ambassador that his idea is that the contracts be "ratified" by the Parliament, thus giving them a status superior to contravening legislation and a much better chance of surviving post-Nazarbayev scrutiny. It is not clear that the companies will eagerly agree to have their confidential contracts exposed to parliamentary (and public) scrutiny, but the threat of imposing the new tax code due to be adopted by the end of the year regardless of stabilization clauses could be a very significant bit of

leverage. Masimov broached this idea with O'Reilly during his recent visit. O'Reilly apparently was not expecting this approach, and said that he would consult with the company's lawyers and provide a response later. TCO has resisted joining EITI because of concerns about publicly revealing certain portions of their contract.

Comment

Sulfur at Tenghiz is hardly Kazakhstan's most pressing environmental problem, particularly when TCO is making a good-faith effort to accelerate pad removal. With a series of extravagant fines and unrelenting pressure, however, the GOK risks creating a serious rift with TCO. While there are many factors at play - the populist appeal of taking on the IOCs, the budget pressures created by an economic downturn, simple greed - a primary cause for conflict the appears to be that bureaucratic elements, including the Environmental Ministry and Tax Committee, are pursuing their own agendas aided by tough interpretations of ambiguous legislation. The GOK leadership must sort out this situation by reducing the pain to the oil companies to a manageable level. Simultaneously, they have to avoid providing the opposing bureaucrats (and the procuracy and financial police lurking in the background) with ammunition to accuse them of selling out the country or violating the law.

ORDWAY